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No. 126

IN THE

Supreme Court of the United States

October Term, 1948

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

PHILADELPHIA TRANSPORTATION COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 872

Commissioner of Internal Revenue, Petitioner

v.

Philadelphia Transportation Company.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

OPINIONS BELOW.

The opinion of the Tax Court (R. 17-37) is reported at 9 T. C. 1018. The opinion of the Court of Appeals (R. 97-100) is reported at 174 F. 2d 255.

JURISDICTION.

The judgment of the Court of Appeals was entered on March 21, 1949 (R.101). The petition for a writ of certiorari was filed on June 16, 1949. The jurisdiction of this Court is invoked under Title 28 U. S. C., Section 1254(1).

QUESTIONS PRESENTED.

1. Where an accrual basis taxpayer upon incorporation in 1940 issued its bonds dated January 1, 1939, pursuant to a plan of reorganization under Section 77B of the Bankruptcy Act, are amounts paid in 1940 to redeem interest coupons for 1939 deductible in 1940 as accrued interest under the Internal Revenue Code?

2. Where the Commissioner of Internal Revenue does not disallow a deduction claimed on a taxpayer's federal income tax return within the statutory period for assessing additional income tax, may he thereafter, upon examination of the taxpayer's return for a later taxable year, disallow the deduction and reduce the loss carried forward to such later year under the Internal Revenue Code?

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved may be found in the Appendix, *infra*, pp. .

STATEMENT.

The Philadelphia Rapid Transit Company, a Pennsylvania Corporation (one of Respondent's predecessors), operated a street railway system in Philadelphia under long-term leases. In 1934 it filed a voluntary petition under Section 77B of the Bankruptcy Act (R. 19). Thereafter two plans of reorganization were filed, but because of objection of interested parties, neither was approved by the Court. Finally, a third plan known as the Second Revised Plan was filed on December 1, 1937, and amended on June 1, 1938, and November 15, 1938. This Plan was approved by the Court on November 14, 1939 (R. 19, 39).

It provided for the consolidation and merger of sixty-

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five of the corporations previously constituting the Philadelphia Rapid Transit Company system, and pursuant thereto an Agreement of Consolidation and Merger was adopted by these corporations (R. 22). The Plan and Agreement provided that Respondent, Philadelphia Transportation Company, a new corporation (who will be referred to in this Brief as the taxpayer) would result from the merger and consolidation of the old companies (R. 22). It also provided that the taxpayer would issue its Consolidated Mortgage Bonds to holders of stock and stock trust certificates of certain of the merging companies in exchange for their stock which would be cancelled in the merger and consolidation (R. 20; Exhibit 6-F, R. 81). In addition the Plan required the taxpayer to issue certain Consolidated Mortgage Bonds to holders of First Mortgage Bonds of two of the merging companies in exchange for their old bonds (R. 20, 21).

Pursuant to the Plan and the Agreement of Consolidation and Merger the taxpayer was incorporated on January 1, 1940 (R. 25). As required by the Plan of Reorganization, the taxpayer on January 29, 1940, issued its Consolidated Mortgage Bonds which were dated January 1, 1939 (R. 25). When the taxpayer opened its books as of January 1, 1940, it set up as a liability the interest due for 1939 in accordance with the provisions of the bonds (R. 27, 28). On January 29, 1940, and June 28, 1940, the taxpayer redeemed the interest coupons for 1939 (R. 29, 30).

In its Federal income tax return for the calendar year 1940 the taxpayer claimed a deduction for this interest paid in 1940 as interest accrued in 1940 (R. 32). The taxpayer had a loss for the calendar year 1940 which it carried over to the calendar year 1942 as a net operating loss deduction in accordance with the provisions of the Internal Revenue Code (R. 32). Petitioner disallowed the deduction for accrued interest in computing the net operating loss for 1940 to be carried over to 1942 (R. 32).

The period for assessment of additional tax with respect to the year 1940 expired not later than August 15, 1944 (R. 32). Petitioner examined the taxpayer's return for the year 1940 and advised it on January 19, 1943, that he would accept the return as filed (R. 34). Thereafter, no redetermination of the taxpayer's liability was made until the deficiency notice in this proceeding was mailed on October 8, 1945. In both the Tax Court and the Court of Appeals the taxpayer contended, in the alternative, that petitioner was obliged to recognize the deduction claimed because he did not challenge it in time. In view of their decision for the taxpayer on the first question, neither the Tax Court nor the Court of Appeals passed upon this alternative contention.

ARGUMENT.

1. This case involves the deduction of interest under Section 23(b) of the Internal Revenue Code.[1] This section permits a taxpayer to deduct all interest paid or accrued within the taxable year on indebtedness except interest incurred or continued to purchase or carry tax free obligations.

The requirements of the Statute are clearly met in this case.[2] The bonds constitute indebtedness. This no one challenges. Likewise the payments in question constituted interest. The amounts were paid as interest pursuant to the plan of reorganization (R. 48), pursuant to the consolidated mortgage bonds themselves (R. 81), and pursuant to the coupons in redemption of which the pay-

[1] Appendix, *infra*, p. 15.

[2] The requirement of payment and the statutory exception are eliminated from consideration in this case because the taxpayer is on the accrual basis and it was stipulated that the indebtedness involved was not incurred or continued for the excepted purpose (R. 3, 14).

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ments were made (R. 88, 89). The payments constituted the price of borrowed money and were clearly interest as that term is understood in the business community. Indeed, the petitioner himself, in a ruling issued to the taxpayer, held that the payments were interest (R. 90). Finally, the interest accrued in 1940, the year in which the taxpayer came into existence and issued its bonds (R. 7).

2. Petitioner urges conflict between the present case and *Commissioner* v. *Drovers Journal Publishing Co.*[3] as a reason for granting the writ in this case. While the decisions appear to be in conflict, the taxpayer submits that the decision in the *Drovers Journal* case, decided in 1943 and never followed, was wrong because it was based upon unsound grounds. The Court of Appeals for the Seventh Circuit did not believe that its decision in the *Drovers Journal* case was contrary to that of the Court of Appeals for the Ninth Circuit in the earlier case of *Commissioner v. Columbia River Paper Mills*[4] where a similar interest deduction was allowed. The Seventh Circuit thought the two cases were distinguishable and it is at this point that the Court fell into error.

It sought to distinguish the *Columbia River* case on the ground that the taxpayer in that case had exchanged its bonds for its own preferred stock, on which there were dividend arrearages. Thus, according to the Seventh Circuit, no new indebtedness was created upon the issuance of the bonds because they merely refinanced a pre-existing indebtedness, whereas in the *Drovers Journal* case the capital notes were not issued for a pre-existing indebtedness of the taxpayer.

This distinction which the Court of Appeals attempted to make finds no support in the facts, because the *Colum-*

[3] 135 F. 2d 276 (7th Cir. 1943), reversing B. T. A. memo. dec., CCH Dec. 12,521-C.

[4] 126 F. 2d 1009 (9th Cir. 1942), affirming 43 B. T. A. 104.

bia River notes were not issued to finance a pre-existing indebtedness.[5]

The seeming conflict between the present case and the *Drovers Journal* case stems not so much from a contrariety of view as to the interpretation of Section 23(b) of the Internal Revenue Code as from an erroneous application of certain basic principles of corporate law in the *Drovers Journal* case.

The *Drovers Journal* case has uniformly been regarded as unsound and has not been followed by any court. Indeed, the petitioner himself has apparently had some misgivings about the case because, having had ample opportunity heretofore to seek this Court's decision, he has instead acquiesced in the Tax Court's adverse decision in one case,[6] agreed to a dismissal of his petition for review by the Court of Appeals in another,[7] and failed to seek a writ of certiorari in two cases, one of which was decided by the same circuit which decided the present case.[8]

3. Petitioner contends that "some of the '1939 interest' plainly amounted to a payment by the taxpayer of the obligations of its predecessor companies—*i. e.*, obligations which it had assumed as part of the purchase price of their assets,"[9] because, according to the peti-

[5] The preferred stock dividend arrearages did not constitute an indebtedness of the corporation. It is well settled that undeclared dividends, even though cumulative and in arrears, do not give rise to a debtor-creditor relationship between the corporation and its shareholders. See 11 FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 5321 (Perm. ed. 1932).

[6] *The Ernst Kern Co.*, 1 T. C. 249 (1942), A. 1944 CUM. BULL. 16.

[7] *Oregon Pulp & Paper Co.*, 47 B. T. A. 772, petition for review dismissed on the authority of *Commissioner* v. *Columbia River Paper Mills, supra*, on stipulation of the Commissioner (9th Cir., November 2, 1943).

[8] *Commissioner* v. *Columbia River Paper Mills, supra*, and *Commissioner* v. *Pressed Steel Car Co.*, 152 F. 2d 280 (3rd Cir. 1945), affirming per curiam T. C. memo. dec., CCH Dec. 14,100(M).

[9] In framing his statement of the question presented (Pet. 2) petitioner says that the taxpayer's bonds were issued in exchange for assets. The bonds were not in fact so issued. They were issued to security holders of the predecessor companies in connection with the 77B reorganization of the taxpayer and were not issued in exchange for assets (R. 20).

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tioner, the taxpayer could not properly have paid the 1939 income interest as its own obligation since it had no income and "so would have been precluded from paying such interest by the terms of the reorganization plan."[10] On the contrary, the taxpayer was *required* by the terms of the plan of reorganization to pay the 1939 interest as *its own obligation* because the plan provided that upon confirmation the reorganization should "become effective as of *January 1, 1939*" (R. 64).[11]

Petitioner also argues that the removal of certain fixed interest coupons from some of the new bonds issued in exchange for old bonds of predecessor companies indicates that the taxpayer treated the interest as paid in discharge of a pre-existing liability assumed in the reorganization.[12] The removal of the coupons was required by the order of the reorganization court[13] and the fact that some security holders, pursuant to the plan of reorganization, received less interest than others in no way demonstrates that the interest was part of the costs of the assets acquired.

Although the petitioner finds an anomaly in treating the 1939 payments as interest and says it can be resolved only by treating them as part of the cost of assets, the taxpayer submits that the anomaly lies in treating the payments as anything other than interest. Entirely apart from the interest payments under consideration, cash in excess of $2,200,000 was paid to the exchanging security holders of the taxpayer's predecessors in accordance with the plan of reorganization (R. 52). If some payment in addition to the $2,200,000 had been contemplated under the plan, it would have been anomalous to have made it indirectly in interest coupons rather than directly as a

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[10] Pet. 6.

[11] The amount of income interest in question was determined on the basis of the income for 1939 reconstructed to give effect to the plan of reorganization as of January 1, 1939 (R. 30).

[12] Pet. 6.

[13] Exhibit Q, Order No. 901.

further cash payment. The reorganization court would not have countenanced such a subterfuge.

Contrary to the petitioner's assertion, the interest in question was not paid "in discharge of the liabilities, accrued before the consolidation and merger, of [the taxpayer's] predecessor companies".[14] No obligation to discharge any pre-existing liabilities was imposed upon the taxpayer by the plan of reorganization. When the taxpayer paid the interest in question it was paying interest on its own obligation newly created in 1940 and not on the obligation of a third party. The taxpayer did not assume an existing liability on which interest had already accrued and consequently the interest paid by the taxpayer was clearly not part of the cost of the assets.

Petitioner himself has previously held that the payments in question constituted interest and not part of the cost of the assets. In advising the taxpayer that it was required to withhold income tax on payments made to nonresident alien bond holders, petitioner ruled that: "The distribution under consideration in the instant case is held to *represent a payment of interest on an outstanding obligation*" (R. 91). (Emphasis supplied.)

Petitioner suggests[15] that this case involves "the propriety of the deduction by a taxpayer on the accrual basis of 'interest' for two years in a single year". While he makes no reference to them, petitioner includes Section 43 of the Internal Revenue Code and Section 19.43-2 of Regulations 103 in his Appendix and it is these authorities upon which petitioner presumably relies in claiming that there is here an improper "double" interest deduction. The taxpayer submits that the Code and the Regulations, instead of supporting the petitioner's view, in fact support the taxpayer's position. Section 43 provides that deductions "shall be taken for the taxable year in which 'paid or accrued' * * * unless in order to clearly

[14] Pet. 6.

[15] Pet. 3, fn. 2.

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reflect the income the deductions or credits should be taken as of a different period * * *".[16]

Under this section the interest was deductible in 1940 because it accrued in 1940. It would have been improper to deduct it in any other year. That some other interest also accrued in the same year in no way changes this conclusion. Nor do the accounting requirements of the Public Utility Commission of Pennsylvania have any significance in this case.[17] The accounting requirements of the Commission are designed to supply statistical data in aid of regulation and rate making. Furthermore, the requirements of federal or state regulatory bodies are not determinative of Federal tax liability.[18]

Based upon the argument that some part, if not all, of the sum in question was paid in discharge of liabilities of taxpayer's predecessors accrued before the consolidation and merger, petitioner sees a conflict between the decision in this case and *Rodney, Inc.* v. *Commissioner*.[19] The deduction disallowed in the *Rodney* case was interest

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[16] Compare *Security Flour Mills Co.* v. *Commissioner*, 321 U. S. 281 (1944), in which this Court observed (at pp. 286, 287) that "the uniform result [of the application of Section 43] has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount." The Court observed (at pp. 285, 286) that the exception in Section 43 "was not intended to upset the well-understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer."

In *Dixie Pine Products Co.* v. *Commissioner*, 320 U. S. 516 (1944), this Court again said (at p. 519) that it "has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year."

[17] See Pet. 6, fn. 3.

[18] *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552 (1932); *East Penn Transportation Co.*, 6 T. C. M. 1097 (1947).

[19] 145 F. 2d 692 (2d Cir. 1944).

on a predecessor's bonds which accrued prior to the date of liquidation and assumption of liability by the taxpayer. As was pointed out above, no part of the interest in the present case was paid in discharge of the liability of a third party or of the taxpayer accruing before the consolidation and merger. Thus there is no conflict with the *Rodney* case. Actually, the two cases are in accord rather than in conflict because the interest which accrued from the date the taxpayer assumed its predecessor's obligation in the *Rodney* case, was allowed as a deduction, being interest on the taxpayer's own indebtedness. Similarly in the present case the interest in question was interest on the taxpayer's own indebtedness, and hence was properly deductible.

4. Petitioner suggests that *Pratt-Mallory Co.* v. *United States*[20] "seems also to be in conflict with the instant case."[21] *Pratt-Mallory* is clearly distinguishable because it obviously turned on the peculiar facts involved. There, through a series of errors commencing when the taxpayer mistakenly reported another's income as its own, the taxpayer finally reached the position where it was endeavoring to deduct the same item twice. The Commissioner, adopting an equally untenable position, sought to deny any deduction at all. The Court of Claims, quite properly it would seem, held that the taxpayer was entitled to deduct the item once, and only once. It will be observed that the *Pratt-Mallory* case was decided prior to any of the cases which involved the precise question here being considered. Presumably it was not thought to be in point in those cases and, indeed, in the present case both the Tax Court and the Court of Appeals expressly said it was not (R. 36, 99, fn. 4).

5. It should be observed that in cases such as the present the Federal revenues are amply protected by

[20] 12 F. Supp. 1020 (Ct. Cl. 1936).

[21] Pet. 5.

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statute. The Secretary of the Treasury is given the right under Chapter X of the Bankruptcy Act to object to a plan of reorganization which has for one of its principal purposes the avoidance of taxes,[22] and if the reorganization judge is satisfied that a tax avoidance purpose exists, he must refuse to confirm the plan. The Secretary participated in the reorganization in the present case. He would most certainly have objected to confirmation if he had thought, as petitioner now does, that security holders in the predecessor companies were to receive, in addition to the cash payment exceeding $2,200,000 as provided in the plan, a further cash payment disguised as interest solely in order that taxpayer might reap a tax benefit.

We believe that petitioner has mistakenly overestimated the practical importance of the present question in the administration of the Internal Revenue Code. He has apparently overlooked the powers already conferred upon the Secretary of the Treasury by the Congress in the enactment of amendments to the Bankruptcy Act.

6. Entirely apart from the question of the deductibility of the interest on the merits, the decision of the Court of Appeals was in fact correct for a reason not stated by the Court. The interest deduction in question was once allowed by the petitioner and he therefore cannot now disallow it after the period for assessment of additional tax for 1940 has expired.[23]

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[22] Section 266 of the Act (11 U. S. C. § 666) provides that the Secretary shall be informed of reorganization proceedings and Section 269 (11 U. S. C. § 669) authorizes him to appear and object to the confirmation of any plan which involves tax avoidance. Such objection is required to be heard and determined independently of any other objections which may be made to the confirmation of the plan.

[23] Because their decision was for the taxpayer on the first point neither the Tax Court nor the Court of Appeals discussed this alternative contention which was pressed by the taxpayer in both Courts. Nor did the dissenting judge in the Court of Appeals discuss this argument although a discussion of the second point would appear to be necessary to a complete disposition of the case in view of his opinion against the taxpayer on the first point.

Section 122(a)[24] of the Code defines the net operating loss which may be carried over from one year to another as the "excess of the deductions allowed by this Chapter over the gross income, with the exceptions, additions and limitations provided in subsection (d)."[25] Under this statutory definition it follows that if the deductions claimed by the taxpayer on its 1940 return have been "allowed" within the meaning of Section 122(a), the Commissioner erred in disregarding them in determining the taxpayer's income tax liability for 1942.

The meaning of the word "allowed" as used in a substantially identical section of the Internal Revenue Code[26] has already been defined by this Court. In *Virginian Hotel Corporation of Lynchburg* v. *Commissioner*[27] this Court defined the meaning of the word "allowed" as follows:

> "* * * 'allowed' connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are 'allowed', since tax liability is then determined on the basis of the returns. Apart from

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[24] Appendix, *infra*, p. 15.

[25] The "exceptions, additions and limitations provided in subsection (d)" are not applicable to this case.

[26] Section 113(b)(1)(B), which was involved in the *Virginian Hotel* case provides:

"(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

"(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent *allowed* (but not less than the amount allowable) *under this chapter* or prior income tax laws. * * *." (Emphasis supplied.)

Section 122(a) involved in the present case provides:

"Definition of Net Operating Loss. As used in this section, the term 'net operating loss' means the excess of the deductions *allowed by this chapter* over the gross income, with the exceptions, additions, and limitations provided in subsection (d)." (Emphasis supplied.)

[27] 319 U. S. 523 (1943).

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contested cases, that is indeed the only way in which deductions are 'allowed'."[28]

Under this definition of the word "allowed" it follows that all deductions, including the interest deduction in question, claimed by the taxpayer on its 1940 return were "allowed" within the meaning of Section 122(a) of the Code. Petitioner accepted the taxpayer's return for 1940 as filed, advising the taxpayer of that fact, and did not make any change in it prior to the expiration of the statutory period for doing so (R. 32). Petitioner was, therefore, obliged by Section 122(a) to recognize such deductions in computing the taxpayer's net operating loss for 1942. His present attempt to disallow them came too late.

CONCLUSION.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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[28] 319 U. S. at p. 527.



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APPENDIX.

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

SEC. 122. NET OPERATING LOSS DEDUCTION.

(a) DEFINITION OF NET OPERATING LOSS.—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

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